Interest Rates and Investment Property Values

The price of investment property and real estate held for investment is closely related to mortgage interest rates and to the bond market. Understanding this interest rate correlation can aid an investor in their decision to buy, sell, or hold an investment property.

Interest Rates and Borrowing

Most investment real estate is leveraged or purchased with debt. The investor will use their own capital along with a loan from a bank, an insurance company, or another investor to purchase the property.

A larger interest rate will increase the monthly payment on a loan. Real estate investors and lenders desire the income from a property to cover the monthly payments. If rents are not increasing at the same rate as interest rates, a property's value will decrease.

Imagine with me an investment property that provides an investor with $1,000 per month of net operating income after paying expenses. At 4.25% interest on a 30-year fixed mortgage an investor could borrow about $203,000. If the interest rate increases to 5.25%, the borrower could only borrow $181,000.

Interest Rates and Property Values

For simplicity's sake, we will assume that an investor is going to have a down payment of 25% and will finance 75% of the property's price. With an interest rate of 4.25% an investor can afford a property worth $271,000 and a mortgage of $203,000. At an interest rate of 5.25% an investor could only afford a property worth $241,000 with a mortgage of $181,000.

The cost of financing has reduced the buying power of the investor. The investor needs a lower price point to afford the same property that produces $1,000 of monthly income.

Arguably, the value of the property must decrease to entice an investor to buy. A 1% increase in mortgage interest rates has the effect of lowering the value by $30,000 an approximate loss of 11%.

Interest Rates, Risk, and Cap Rates

Real estate competes for the investment dollars of rational investors. Investment theories dictate that an intelligent investor will compare like investments depending upon risk and reward. Given the choice to choose a less risky investment for the same return as a riskier investment, a rational investor would choose the less risky investment.

Real estate competes for the investment dollars of rational investors. Real estate is viewed as a riskier investment than bonds and blue-chip stocks. An investor will demand a higher return for the greater risk associated with real estate.

If the return on mortgage-backed securities (a type of bond) increases, the resultant return required for an investment in real estate will increase.

This reflection of return is expressed through the capitalization rate (cap rate). The cap rate is calculated by dividing the net operating income of a property by the value or price of a property.

Cap rates and prices are inversely related. As cap rates rise, values decrease. As cap rates fall or decrease, values increase.

When interest rates rise, cap rates rise to compensate for the additional risk associated with being an equity investor in real estate. Rising cap rates decrease a property's value. When interest rates decrease, cap rates can decrease or compress with the mortgage rate. Decreasing cap rates increase a property's value.

Putting it All Together

Interest rates are an important part of the value equation in real estate. Rising interest rates will generally result in lower property values over the long run. Low and falling interest rates will generally result in higher property values over the long run.

Real estate investors can use interest rate trends in their investment decisions. Real estate investors wanting to buy a property might do well to wait when interest rates are rising and to pull the trigger quickly when rates are trending down. Real estate sellers would be wise to sell when they see rates trending higher and to wait when interest rates decline.

Source: https://www.maclennaninvestments.com/articles/interest-rates-and-investment-property-values/